Asset class spotlight: fixed income

DWS executives weigh in on how investment strategies have adapted in a highly volatile period.

By Shawn Moynihan, Editor-in-Chief

DWS' Robert McCollum, Head of Portfolio Management-Fixed Income Solutions, and Lloyd Ayer, Head of Solutions-Americas, discuss with *Reactions* asset managers' challenges faced in the wake of the global markets' response to the pandemic, what opportunities emerged, and the perils of searching for yield in uncertain times.

What kind of dislocation did insurance asset managers experience or observe during the March period of volatility, and into April?

Events during that period put operational pressure on insurers from a number of fronts as investment personnel fielded a higher-than-usual volume of inquiries from boards and ratings agencies regarding the financial impact to investment portfolios and capital. Additionally, some insurers may be looking to build liquidity buffers due to heightened premium or claim stressors; this was a challenging objective in mid-March specifically given market illiquidity.

Certainly, the volatility in markets was extreme. Equity VIX set an all-time record of 82.69 on 16 March, the S&P 500 experienced its fastest sell-off in history (declining 34% from the 19 February peak to the 23 March low), primary investment-grade corporate bond issuance set a record in March at $259bn as companies sought liquidity while spreads on the Bloomberg Barclays Corporate Bond Index widened from 95 on 24 February to 373 on 23 March.

Importantly, liquidity in markets evaporated. Commercial paper funding was strained, short duration corporates widened significantly as accounts looked to raise cash, and even Treasury bonds and notes (particularly off-the-runs and TIPs) had wide bid/offer spreads and liquidity challenges. The Fed intervened aggressively, cutting rates, announcing massive asset purchases and an alphabet soup of lending and purchase facilities which served to calm markets, capped by the 9 April announcement of an additional $2.3trn of financing which further rallied markets and improved liquidity.

Did pockets of opportunity emerge in fixed income that previously were considered overvalued?

In retrospect, one could say some spread or non-Treasury sectors were overvalued, though by historical measures and given the previous state of the U.S. economy, one could certainly argue that a number of sectors were fairly valued. Nonetheless, levels have changed considerably given what transpired.

So, while numerous pockets of opportunity emerged, here is a specific example: In the depths of the sell-off, high yield spreads surpassed 1000 and average bond prices fell below $80. This was only the third time in history that has occurred, and it has historically represented a buying opportunity. For companies with the investment flexibility and available risk budget, this may have been an opportunity to add exposure to capture equity-like returns with less downside volatility.

With all the stimulus injected into the market, are there concerns or areas where you are keeping careful watch?

There are no near-term concerns. Looking out further, Federal debt to GDP, even at these low interest and tax rates, could temper growth prospects. Corporate borrowing is certainly ballooning, and the speed of balance sheet recovery is in question given the uncertainty on how long before we return to life as we knew it. Finally, one must pay attention to how gold has responded in the wake of all the central bank "money printing"; this top-performer's bull market may be just getting underway.

Do events such as these alter how you would position a core fixed income strategy? Are you taking a new look at sectors because of what might have happened?

Certainly, the widening in credit spreads created an opportunity in investment grade credit. March's primary calendar provided an excellent opportunity to add exposure in high-quality borrowers, and through mid-April the Fed had not yet begun purchasing corporates; the market rallied in anticipation of them doing so. We believe support for short-dated investment grade corporates will be a strong technical for the next couple of quarters. Similarly, the announcement of TALF 2.0 will support structured finance securities that are eligible. Moreover, there are good opportunities in non-eligible paper that widened commensurately.

How would you extend risk to obtain yield, or has the volatility presented investors with new yield opportunities? Do you need to 'get creative'?

Given the valuations and the yields available pre-crisis, certain portfolios were underweight risk going into Q1. As a result, some insurers are in a position to take advantage of opportunities within existing mandates or allocate cash to rebalance. The deciding factor is how one was positioned relative to their strategic asset allocation. The repricing of risk assets creates an opportunity without having to reinvent the process or be overly creative.

One must be careful on the search for yield, though. Certain sectors have higher exposure to the crisis, and will take longer to recover.